### STATE OF WASHINGTON OFFICE OF THE INSURANCE COMMISSIONER



# FINANCIAL EXAMINATION OF PEMCO MUTUAL INSURANCE COMPANY SEATTLE, WASHINGTON

**NAIC CODE #24341 DECEMBER 31, 2003** 

Participating States: Washington

#### **CHIEF EXAMINER'S AFFIDAVIT**

I hereby certify I have read the attached Report of the Financial Examination of the PEMCO MUTUAL INSURANCE COMPANY of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 2003.

Patrick H. McNaughton

**Chief Examiner** 

5-18-05

Date

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#### **SALUTATION**

Seattle, Washington May 17, 2005

The Honorable Alfred W. Gross, Commissioner Chair, NAIC Financial Condition (E) Committee State Corporation Commission Bureau of Insurance Commonwealth of Virginia PO Box 1157 Richmond, VA 23218

The Honorable Linda Hall, Director Alaska Division of Insurance Secretary, Western Zone 550 West 7<sup>th</sup> Avenue, Suite 1560 Anchorage, AK 99501-3567

The Honorable Mike Kreidler, Commissioner Washington State Office of the Insurance Commissioner (OIC) Insurance 5000 Building 5000 Capital Blvd. Tumwater, WA 98504-0255

Dear Commissioners and Director:

In accordance with your instructions and in compliance with the statutory requirements of RCW 48.03.010, an examination was made of the corporate affairs and financial records of

## PEMCO MUTUAL INSURANCE COMPANY of Seattle, Washington

hereinafter referred to as "PMIC" or the "Company", at its home office located at 325 Eastlake Avenue East, Seattle, Washington 98109-5466. The following report on the examination is respectfully submitted showing the condition of the Company as of December 31, 2003.

#### **SCOPE OF EXAMINATION**

This examination covered the period January 1, 1999 through December 31, 2003 and comprised a comprehensive review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Administration Code (WAC), the Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (FCEH). The examination included identification and disposition of any material transactions and events occurring subsequent to the date of examination that were noted during the examination. The findings of the previous examination report were reviewed and all items were satisfactorily addressed.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. In addition, the Company's certified public accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

#### **INSTRUCTIONS**

The examiners reviewed the Company's filed 2003 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW and Title 284 WAC, and the NAIC Statements of Statutory Accounting Principles (SSAP) as contained in the NAIC Accounting Practices and Procedures Manual (AP&P).

The following summarizes the exceptions noted while performing this review.

#### 1. Conflict of Interest

PMIC's Conflict of Interest Policy requires that conflict of interest disclosures be updated every three years. For the examination period, there was only one disclosure form each for one officer and one director, although the other officers and directors complied with the policy.

RCW 48.05.370 states, "officers and directors of an insurer... shall be deemed to stand in a fiduciary relation to the insurer, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions." In order to monitor compliance with this statute, the Company is instructed to obtain and review conflict of interest declarations from appropriate

personnel and to report the results to the Company's Board of Directors, as required by the Conflict of Interest Policy

#### 2. Custodial Agreement

In the 2003 NAIC Annual Statement Interrogatory #22.01, the Company stated that its Custodial Agreement with US Bancorp complied with the NAIC Financial Condition Examiner's Handbook. However, the Company's agreement contained the following deficiencies:

- The Agreement does not allow PMIC's securities that are not held subject to deposit requirements to be withdrawable upon demand.
- For the loss of securities which US Bank is obligated to indemnify PMIC, the Agreement does not clearly require US Bank to promptly replace the securities or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities.
- The Agreement does not require US Bank to allow an officer or employee of PMIC, an independent accountant selected by PMIC, and a representative from the OIC, to be entitled to examine US Bank's records relating to the securities on the premises of US Bank during regular business hours.
- To the extent that certain information maintained by US Bank is relied upon by PMIC in preparation of its annual statement and supporting schedules, the Agreement does not require US Bank to maintain records sufficient to determine and verify such information.
- The Agreement does not require insurance by the custodian.

The Company is required to follow the NAIC's Annual Statement requirements as noted in WAC 284-07-050(2). Adherence to the FCEH is one of these requirements. The Company is instructed to correct all deficiencies noted above and execute a revised or amended custodial agreement.

#### 3. Internal Audit Department

During the period covered by our examination the internal audit department performed 16 audits. This coverage should be evaluated by comparing it to an objective prioritization of significant, sensitive control areas and cycles. If it is found to inadequately cover the required areas in either scope or frequency, consideration must be given to strengthening the department or refocusing its mission. Currently, the department consists of three professionals and the organization charts show that its resources are diverted to other tasks such as contract administration. This situation is of particular concern, since the Company has no Audit Committee to monitor the department's scope, coverage or results.

The Company is instructed to comply with RCW 48.05.370, which states that officers and directors "...shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions". This should include creating an Audit Committee which would be responsible for ensuring that the Internal Audit Department adequately covers significant, sensitive control areas and avoids even the appearance of subjectivity by devoting all its resources to performing internal audits.

#### 4. Drafts versus Checks

The Company issues negotiable instruments for claims payments and accounts for them as drafts while its bank considers them to be checks. According to SSAP #2 paragraph 6, a draft is paid only upon approval by the reporting entity. This is not the case with PMIC. By reporting the claims payments as drafts versus checks, the Company records a draft liability. The entry should have been a credit to cash.

Pursuant to RCW 48.05.073 which requires conformity with NAIC accounting practices, RCW 48.05.250 which requires a "true statement" in the NAIC form and SSAP #2 paragraph 6 and 7, which defines drafts and checks, the Company is instructed to follow the NAIC Annual Statement Instructions and SSAP when preparing its annual statement and to record the claim payments as checks.

#### 5. NAIC Annual Statement Preparation – Intercompany Taxes

The Company reports intercompany receivables/payables arising from participation in its consolidated tax return with its subsidiary, PEMCO Insurance Company, as an intercompany receivable/payable on the annual statement instead of as a tax liability or a tax recoverable.

The Company is instructed to comply with RCW 48.05.250 and file a true statement of its financial conditions, transactions and affairs; with RCW 48.05.073 which requires the filing of its financial statements in accordance with AP&P; and WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions and AP&P.

#### 6. Preemptive Controls Over Claims Processing and Employee Transactions

PMIC issues claims checks either electronically or in the field. The checks issued in the field are signed by the adjuster assigned to the claim. No other signatures are required. If the claim exceeds the adjuster's signing limit, additional authority is given through an "override". This could be 2 to 3 times the adjuster's authority. The claim checks are issued electronically and are preprinted with the treasurer's signature. Even though the adjuster does not have access to the check, there are no controls in place to prevent the adjuster from having the check sent to a PO Box. The internal audit department

uncovered instances where a claims department supervisor was involved in processing his own claim and another employee disguised a premium delinquency on his policy. There are no internal procedures barring employees from processing claims or accounts receivable where they have an interest in the claim or policy. At a minimum, there should be procedures to prohibit such capabilities and to actively search for such relationships using automated search facilities.

The above instances of deficient controls and procedures demonstrate apparent lapses in fiduciary responsibility. Pursuant to RCW 48.05.370, which states that "Officers and Directors of an insurer... shall be deemed to stand in a fiduciary relation to the insurer, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions," the Company is instructed to develop preventive controls in its claim processing and to establish procedures to prohibit employees from processing claims or accounts receivable in which they have an interest.

#### **COMMENTS AND RECOMMENDATIONS**

#### 1. Cash Control

Unidentified receipts are stored in a safe in the Accounts Receivable Department rather than depositing them into a PMIC bank account and placing them under accounting control. If the receipts cannot be identified after 30 days, they are mailed back to the issuer.

It is recommended that the Company immediately enhance its control over cash by depositing unidentified receipts into a bank account.

#### 2. Perception of Governance

Although the PEMCO companies are not publicly held, it is advisable to configure any company's governance and internal control procedures to comply with public company requirements. Currently, the Company's president is included on most important committees and possesses approval authority for most transactions and payment facilities, although there may be cultural and even actual controls to mitigate or offset these powers. This authority may be understood within the Company as being traditional and possibly minimal, but it could give a negative impression to an external party, especially in the absence of an audit committee.

It is recommended that the entire subject of corporate governance, internal controls and approval powers be reviewed and adjusted, if appropriate.

#### 3. Reserving

During our completeness testing of paid and reserved claims, we found one claim which, for more than two years, was not properly reserved, apparently in violation of established claims reserving procedures.

It is recommended that the Company take steps to ensure compliance with established control procedures for establishing and monitoring reserves on open claims.

#### 4. Control of Reinsurance Contracts

PMIC receives reports from its reinsurers analyzing reinsurance pricing and performance with respect to both PMIC's and the reinsurers' results. Negotiation of PMIC's reinsurance contract terms comes directly out of the reinsurers' analyses. The Product Department and Company actuaries coordinate this process, but no one at PMIC is responsible for performing an analysis or developing a rationale for approving its reinsurance contracts.

It is recommended that PMIC analyze, develop a rationale for, and document its process for approval of its reinsurance contracts.

#### 5. Investment Custodian

The Company does not perform a periodic review of the financial condition and capabilities of its investment custodian. It relies on its 30 year business history with the bank as support for its continuing relationship.

It is recommended that the Company perform a periodic review of its investment custodian to ensure that it is meeting expectations.

#### **COMPANY PROFILE**

#### **Company History**

The OIC's previous examination covered the period January 1, 1993 to December 31, 1998.

PMIC was organized as a mutual insurer in the state of Washington during September - October 1948 and commenced business during February 1949 under the name, Public Employees Mutual Insurance Company. In January 1977, pursuant to RCW 48.31.010, the merger of Public Employees Mutual Casualty Company into Public Employees Mutual Insurance Company was approved. The name was later changed to PEMCO Mutual Insurance Company in January 1989. The Company is licensed to operate only in the state of Washington and writes multiple-lines property and casualty coverage for the

general public. PMIC is the ultimate controlling entity in the Insurance Holding Company System.

#### Territory and Plan of Operation

The Company is licensed to operate in the state of Washington.

PMIC utilizes direct and independent agents to acquire new business. Servicing of customers can be accomplished either by an independent agent or by the Company.

#### **Growth of Company**

The Company's growth, as reported in its filed NAIC Annual Statements, is illustrated below.

	<u>Assets</u> <u>I</u>		Capital and Surplus
1999	\$389,034,626	\$223,326,207	\$172,337,110
2000	385,408,687	208,944,743	176,463,939
2001	417,054,306	242,547,614	174,506,693
2002	421,597,348	255,296,055	166,301,293
2003	456,020,773	285,268,927	170,751,845
	<u>Premiums</u>	Net Investment Income	<u>Losses</u>
1999	\$196,976,572	\$12,842,656	\$118,683,658
2000	191,754,365	12,921,845	107,975,379
2001	193,970,376	12,694,022	118,607,923
2002	199,796,087	12,218,850	124,386,032
2003	214,897,523	19,122,964	134,899,558

#### **Affiliated Companies**

<u>PEMCO Corporation (CORP)</u> is a stock company that was incorporated in the state of Washington during 1983. CORP provides data processing services, and leases automobiles and office equipment to the three insurance companies and other companies under common management.

<u>PEMCO Life Insurance Company (PLIC)</u> is a Washington corporation organized as a stock insurance company on May 23, 1963. PLIC is authorized to write participating and non-participating insurance coverages.

Washington State Teachers Credit Union (WSTCU) was founded by Robert J. Handy and a group of educators in 1936. Today, the Credit Union is one of the largest members owned credit unions in the state.

<u>Teachers Credit Company (TCC)</u> was incorporated under the laws of the state of Washington during 1941. TCC retains and exercises the proxy votes of the policy holder members of PMIC.

Evergreen Bank (EB), formerly Teachers State Bank, was incorporated under the laws of the state of Washington on December 28, 1970 and commenced business on October 1, 1971. EB provides banking services for all affiliated companies.

<u>Public Employees Insurance Agency (The Agency)</u> is a stock company incorporated in the state of Washington during October 1968. The Agency sells insurance and collects premium on behalf of the affiliated insurance companies.

**PEMCO Insurance Company (PIC)** was incorporated on May 4, 1972 as a stock multiple line property and casualty insurance company under the laws of the state of Washington. It is 100% owned by PMIC.

#### **Intercompany Contracts**

As of December 31, 2003, the Company was a party to the following intercompany contracts:

Tax Sharing Agreement	January 1, 2001
Shared Services Agreement	January 1, 2000
Cost Sharing Agreement	January 1, 2003
Loss of Surplus Insurance (See Reinsurance, page 10)	January 1, 1991

#### MANAGEMENT AND CONTROL

#### **Board of Directors (BOD)**

As of December 31, 2003, the Company was controlled by a nine-member BOD of which seven are outside directors. All BOD members are elected for a one-year term at the annual stockholders' meeting.

<u>Name</u>	Principal Business Affiliation
Stan W. McNaughton	President and Chief Executive Officer, PEMCO Mutual Insurance Company
Richard S. White	Retired

Ed K. Erickson

Retired

Carl E. Tingelstad

Retired

Roger A. Reimer

Retired

Sandra M. Kurack

President, School Employees Credit Union of Washington

Shirley L. Hodgson

Executive Director, Human Resources Marysville Public School

District

Robert D. Sealey

Retired

Borge O. Saxberg

Professor, University of Washington Business School

#### **Officers**

On December 31, 2003, the officers were:

Stan William McNaughton

President

Steven Anthony Ricco

Treasurer

Richard Stanley White

Secretary

#### **Committees**

PMIC's corporate bylaws provide that the BOD shall designate an Executive Committee at its first regular meeting of each year. Additionally, the BOD has the authority to appoint such additional standing or temporary committees as the Board deems necessary. Active committees during the period of the examination were the Executive Committee, the Investment Committee, a Proxy Committee, a Nominating Committee and an Executive Compensation Committee. None of these committees kept minutes that were submitted to the BOD.

#### **Conflict of Interest**

All affiliated companies have a combined Conflict of Interest and Confidentiality Policy which requires completion of a Conflict of Interest Statement by officers, directors and key employees every three years. All are required to disclose relevant outside interests, memberships, associations and affiliations to the president, chairman, or BOD of the respective company. The Company provided only one Conflict of Interest Disclosure each for one officer and a director. All other officers and directors complied with the policy.

#### Fidelity Bond and Other Insurance

The Company has a Fidelity Institution Bond from Hartford Fire Insurance Company with a Single Loss Limit of Liability of \$5,000,000 and a Single Loss Deductible of \$25,000. This bond covers all Company employees.

#### Officers', Employees', and Agents' Welfare and Pension Plans

The Company offers a 401(k) Savings and Profit Sharing Plan. This is a defined contribution plan where the employer pays eligible employees for their contributions to the continued success of the Company. Employees may contribute up to 15% of their salary to the plan, which is subject to a two-for-one Company match of the first 6%.

The Company offers a non-qualified deferred compensation plan for certain senior executives and directors of the Company.

In addition to deferred compensation benefits, the Company provides certain medical and dental insurance coverage for retired employees. Employees become eligible for these benefits by attaining age 62 with at least 15 years of service.

#### **CORPORATE RECORDS**

The initial Articles of Incorporation were adopted by the Company organizers on September 7, 1948 and were filed with the state of Washington in accordance with the Washington Insurance Code. There have been four subsequent amendments to the original Articles, the latest being in 1989.

The corporate bylaws were amended once during the examination period. On November 15, 2001, the Chairman's duties were revised.

The BOD meetings were well attended and the minutes demonstrated that the BOD members were actively involved in the administration of the Company's affairs. All meetings were documented in writing, noting discussion items, and specific actions taken.

#### LOSS EXPEREINCE

#### **Unpaid Losses and Loss Adjustment Expenses**

The reserves carried by the Company for these liabilities were \$91,416,276 and \$21,503,530, respectively, as of December 31, 2003.

These reserves were reviewed by the casualty actuarial staff employed by the OIC. The Company provided loss and loss adjustment expense development data by accident year

and subline. Actuarial staff obtained additional information by interviewing several Company employees. They also reviewed an actuarial report prepared by PricewaterhouseCoopers, the Company's consulting actuarial firm.

The OIC actuarial staff's estimates indicate that the reserves for both losses and loss adjustment expenses, on a net basis, are within a reasonable range. Therefore, these reserves are accepted as they appear in the Company's 2003 NAIC Annual Statement.

#### **REINSURANCE**

In 2004, the latest year available, the Company retained \$500,000 per property risk for non-boat owners' property, while it had retained \$225,000 in 2003. It retained \$75,000 of boat owners' property in both years. Casualty risks were retained for \$500,000 per occurrence in both years. Maximum cessions to Employers Reinsurance Corporation under these treaties were \$2,500,000 in 2004 and \$1,750,000 in 2003 for each property risk and occurrence and \$3,500,000 for casualty in both years. For umbrella risks coverage in both years, it retained 5% of the first \$1,000,000 and reinsured the remainder of a maximum \$3,000,000. Catastrophic coverage was provided by Lloyds' syndicates for 80% in 2004 and 95% in 2003 of a maximum \$155,000,000, after the Company's \$30,000,000 retention per occurrence.

The Company also has an "Insurance Agreement" with PLIC, whereby PLIC is to be reimbursed up to a maximum of \$500,000 "...for the amount of any surplus loss exceeding \$500,000 as of December 31".

All the contracts have insolvency clauses and other wording generally utilized in such agreements, and the catastrophe coverage excludes terrorism. PMIC assumes no reinsurance.

#### ACCOUNTING RECORDS AND INFORMATION SYSTEMS

The Company maintains its accounting records on a modified GAAP accrual basis of accounting and adjusts to Statutory Accounting Practices (SAP) basis for NAIC Annual Statement reporting. The Company is audited annually by the certified public accounting firm of PriceWaterhouseCoopers. The Company received an unqualified opinion for all years under review. The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning and testing phase of the examination and no exceptions were noted.

The management of the Company is sufficiently knowledgeable of the information systems (IS) process. Systems development, acquisition, and maintenance controls were evaluated to gain assurance that appropriate controls are in place. Operations and application controls were reviewed to determine the type of hardware installed; operating

systems and proprietary software in use; back up and recovery facilities employed; and the controls exercised to maintain data security. Sufficient internal controls are in place and monitored by the Company. The Company's IS Department has the ability to recover from an incident or disaster and has documented these procedures in a detailed, written disaster recovery plan.

#### SUBSEQUENT EVENTS

**NONE** 

#### FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS

All previous report instructions and comments have been corrected.

#### **FINANCIAL STATEMENTS**

Assets, Liabilities, Surplus and Other Funds
Summary of Operations
Reconciliation of Capital and Surplus For the Period Since the Last
Examination

#### PEMCO MUTUAL INSURANCE COMPANY ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS DECEMBER 31, 2003

	BALANCE PER		EXAM	BALANCE PER
	COMPANY	REF	ADJ	EXAM
<u>ASSETS</u>				
Bonds	\$180,230,049		\$0	\$180,230,049
Preferred Stock	6,791,925			\$6,791,925
Common Stock	95,625,165			\$95,625,165
Real Estate - occupied by the company	20,887,868			\$20,887,868
Real Estate - held for production of income	5,261,659			\$5,261,659
Cash and short term investments	32,510,703			\$32,510,703
Receivable for securities	10,138			\$10,138
Aggregate write-ins for invested assets	645,289			\$645,289
Subtotal, cash and invested assets	\$341,962,796		\$0	\$341,962,796
Investment income due and accrued	2,587,416			2,587,416
Uncollected premiums and agents' balances in course of				0
collection	14,314,595			14,314,595
Deferred premiums, agents' balances and installments				0
booked but deferred and not yet due	78,092,271			78,092,271
Amounts recoverable from reinsurers	360,447			360,447
Current federal income tax recoverable and interest	4,992,516			4,992,516
Net deferred tax asset	9,738,410			9,738,410
Guaranty funds receivable or on deposit	352,089			352,089
Receivable from parent, subsidiary and affiliates	3,602,310			3,602,310
Aggregate write-ins for other than invested assets	17,923			17,923
TOTAL ASSETS	\$456,020,773		\$0	\$456,020,773
LIABILITIES	\$01.416.276		\$0	91,416,276
Losses	\$91,416,276		30	21,503,530
Loss adjustment expenses	21,503,530			1,298,727
Commissions payable	1,298,727			13,860,084
Other expenses	13,860,084			
Taxes, licenses and fees due or accrued excluding fit	712,326			712,326 119,611,774
Unearned premiums	119,611,774			* *
Advance premiums	2,406,256			2,406,256
Ceded reinsurance premiums payable	676,711			676,711
Amounts withheld or retained by company as agent or trustee	31,611			31,611
Drafts outstanding	7,485,673			7,485,673
Payable to parent, subsidiary and affiliates	2,083,832			2,083,832
Aggregare write-ins for liabilities	24,182,128			24,182,128
TOTAL LIABILITIES	\$285,268,928		\$0	\$285,268,928

### PEMCO MUTUAL INSURANCE COMPANY ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS (Continued) DECEMBER 31, 2003

	BALANCE PER COMPANY	REF	EXAM ADJ	BALANCE PER EXAM
SURPLUS AND OTHER FUNDS				
Common capital stock	0		0	0
Unassigned funds (surplus)	170,751,845			170,751,845
Capital and surplus	170,751,845		0	170,751,845
TOTAL LIABILITIES, SURPLUS AND OTHER FUNDS	\$456,020,773	_	\$0	<b>\$456,020,77</b> 3

#### PEMCO MUTUAL INSURANCE COMPANY SUMMARY OF OPERATIONS YEAR ENDED DECEMBER 31, 2003

	BALANCE PER COMPANY	REF	EXAM ADJ	BALANCE PER EXAMINATION
STATEMENT OF INCOME				
Underwriting Income				
Premiums Earned	\$214,897,523		\$0	\$214,897,523
Deductions				4.4.4.000 550
Losses incurred	134,899,558			\$134,899,558
Loss expenses incurred	28,697,464			28,697,464
Other underwriting expenses incurred	60,615,154			60,615,154
Total underwriting deductions	224,212,176		0_	224,212,176
Net underwriting gain or (loss)	(9,314,653)		0	(9,314,653)
Investment Income				
Net investment income earned	19,122,964			19,122,964
Net realized capital gains or (losses)	639,795			639,795
Net investment gain or (loss)	19,762,759		0	19,762,759
Other Income				
Net gain or (loss) from agents'or premium balances				
charged off	0			0
Finance and service charges not included in premium	451,133			451,133
Aggregate write-ins for miscellaneous income	0			0
Total other income	451,133		0	451,133
Dividends	0			0
Net income before dividends to policyholders and bef	fore			
federal income taxes	10,899,239			10,899,239
Dividends to policyholders	0			0
Net income, after dividends to policyholders but befo	re			
federal and foreign income taxes	10,899,239			10,899,239
Federal and foreign income taxes incurred	1,665,524			1,665,524
Net income	\$9,233,715		\$0	\$9,233,715
1100 11100 1110	4-,,			

#### PEMCO MUTUAL INSURANCE COMPANY SUMMARY OF OPERATIONS (Continued) YEAR ENDED DECEMBER 31, 2003

	BALANCE PER COMPANY RE		EXAM ADJ	BALANCE PER EXAMINATION
CAPITAL AND SURPLUS ACCOUN	г			
Capital and Surplus, December 31, Previous Year	\$166,301,291			\$166,301,291
				\$0
Net income	9,233,715			\$9,233,715
Change in net unrealized capital gains or (losses)	(2,244,489)			(\$2,244,489)
Change in net deferred income tax	2,340,800			\$2,340,800
Change in non-admitted assets and related items	(4,890,616)			(\$4,890,616)
Aggregate write-ins for gains and losses in surplus	11,144			\$11,144
Net change in capital and surplus for the year	4,450,554		0	4,450,554
Capital and Surplus, December 31, 2003	\$170,751,845		\$0	\$170,751,845

#### PEMCO MUTUAL INSURANCE COMPANY RECONCILIATION OF CAPITAL AND SURPLUS FOR THE PERIOD SINCE THE LAST EXAMINATION

	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
Capital and Surplus, December 31, Previous Year	\$166,301,291	\$174,506,684	\$176,463,933	\$165,708,416	\$158,484,192
Net income	9,233,715	(3,991,426)	1,072,974	10,428,734	2,658,685
Change in net unrealized capital gains (losses)	(2,244,489)	(10,371,926)	(3,147,575)	56,750	10,963,851
Change in net deferred income tax	2,340,800	3,555,598	(411,575)		
Change in non-admitted assets and related item	(4,890,616)	50,830	(1,768,537)	15,746	36,717
Change in excess of of stat reserves over stmt reserves		0		54,281	(152,748)
Cumulative effect of changes in accounting principles			2,320,474		
Other	11,144	2,551,526	(23,010)	200,006	346,411
Contingent Surplus Reserve					(6,628,692)
Net change in capital and surplus for the year	4,450,554	(8,205,398)	(1,957,249)	10,755,517	7,224,224
Capital and surplus on December 31,	\$170,751,845	\$166,301,286	\$174,506,684	\$176,463,933	\$165,708,416

#### NOTES TO FINANCIAL STATEMENTS

The Company has no special consents, permitted practices or orders from the state of Washington.

#### **ACKNOWLEDGEMENT**

The cooperation and assistance of the officers and employees of the Company during the examination are hereby acknowledged.

In addition to the undersigned, Susan J. Campbell, CPA, FLMI; D. Lee Barclay, FCAS, MAAA, ARM; Garth Nelson; Kehinde Ovbiebo; Keith Henderson; CFE, CPA; Constantine Arustamian, CFE, CPA; Michael V. Jordan, CPA, CFE, MHP; and John Jacobson, AFE, all from the Washington State Office of the Insurance Commissioner, participated in the examination and the preparation of this report.

Respectfully submitted,

John Gaynard, CFE, CPCU, CPA

Examiner-in-Charge

Washington State Office of the Insurance Commissioner

John Gaynard, CFE, CPCU, CPA Examiner-in-Charge State of Washington

Subscribed and sworn to before me on this 18<sup>th</sup> day of May, 2005.

Notary Public in and for the State of Washington

S NOTIFY PIECE S-17-08